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In the Supreme Court of the United States

OCTOBER TERM, 1964

No. 113

JOSEPH M. THOMAS and JILL G. THOMAS,
PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The memorandum and order of the district court (R. 36-39) are reported at 205 F. Supp. 194. Its findings of fact and conclusions of law (R. 44-52) are not reported. The opinion of the court of appeals (Pet. App. 1-18)[1] is reported at 329 F. 2d 119.

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[1] "Pet. App." references are to Appendix B to the petition.

JURISDICTION

The judgment of the court of appeals was entered on March 12, 1964. (R. 136.) A petition for rehearing was denied on April 14, 1964. (R. 137.) The petition for a writ of certiorari was filed on May 22, 1964. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the court below erred in holding that the taxpayers' interests in oil and gas properties were net profits interests, rather than leasehold interests, for percentage depletion purposes.

STATUTES INVOLVED

Internal Revenue Code of 1954 (26 U.S.C., 1958 ed.):[2]

> SEC. 611. ALLOWANCE OF DEDUCTION FOR DEPLETION.
>
> (a) *General Rule.*—In the case of mines, oil and gas wells, other natural deposits, and timber, there shall be allowed as a deduction in computing taxable income a reasonable allowance for depletion * * *.
>
> * * * * *
>
> SEC. 613. PERCENTAGE DEPLETION.
>
> (a) *General Rule.*—In the case of the mines, wells, and other natural deposits listed in sub-

[2] Sections 23(m) and 114(b) of the Internal Revenue Code of 1939, applicable to the taxable year 1953, are substantially the same as the quoted sections of the 1954 Code.

section (b), the allowance for depletion under section 611 shall be the percentage, specified in subsection (b), of the gross income from the property excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. * * *.

(b) *Percentage Depletion Rates.*—The mines, wells, and other natural deposits, and the percentages, referred to in subsection (a) are as follows:

(1) 27½ percent—oil and gas wells.

* * * *

STATEMENT

The Quality Oil Company was the sublessee of certain oil and gas leases. In March 1948, it assigned a 70% undivided interest in the leases[1] to the Richfield Oil Corporation subject to an "Operating Agreement" under which Richfield, designated as the "operator" of the property, was to finance the development of the property and market the production. The gross revenues were to be credited to a "joint account" from which all the development and operating expenses were first to be paid (including reimbursement of Richfield for its expenditures) and the balance, defined as the "net proceeds," was to be distributed 70%

[1] The March 1948 transaction in fact covered only a part of the area of the leases. Assignments of additional areas were made to Richfield in April 1948 and to the Hancock Oil Company in July 1948 (Pet. App. 9-10). All of the transactions were substantially identical, however, and for simplicity we will treat the case as involving a single assignment.

to Richfield and 30% to Quality.[4] Quality was not personally liable for any expenses incurred, and for recovery of the amounts expended by it for development and operation Richfield could look to the production from the property (Pet. App. 2-8).

In 1949, the operating agreement was amended to declare Quality the "owner" of 30% of the oil and gas produced and to provide that each party could sell its share of the production. Quality was to be liable for expenses only to the extent of the proceeds from the sale of its share of production. It was further provided that Quality would sell its share of the production to Richfield at the going market price and that Richfield could withhold 30% of the expenses from the price paid (Pet. App. 10-11).

Quality subsequently assigned to petitioners one-third of its retained interest in the properties. In each of the taxable years 1953 and 1954, the proceeds from production exceeded expenses, and petitioners accordingly received 10% of the net proceeds. In their income tax returns for those years, petitioners included only the *net* proceeds in their gross income, claimed no deductions for expenses, and claimed a percentage depletion deduction based only on the net proceeds received. In this action, petitioners seek a refund based upon the inclusion in their

[4] Richfield purportedly paid Quality $40,000 for the assignment, but by the terms of the agreement that amount was required to be deposited to the joint account for use for development. That payment was, therefore, no different in substance from the other amounts expended by Richfield for the development of the property.

gross income of the *gross* proceeds from the sale of 10% of the production, a deduction for 10% of the expenses of production, and a percentage depletion deduction based on the gross, rather than the net, proceeds from production. Since including the gross proceeds and deducting the expenses produces, in the circumstances of this case, the same result as including only the net proceeds (as originally reported), the only issue of practical importance is the computation of the percentage depletion deduction—*i.e.*, whether the petitioner's "gross income from the property" (the basis on which percentage depletion is computed, § 613(a)) consists of (a) the net proceeds payable to them by Richfield under the operating agreement or (b) the gross proceeds from the production prior to the payment of expenses. The court of appeals, reversing the district court, denied the increased depletion deduction, holding that in economic substance petitioners had only a "net profits" interest in the property rather than a share of the gross production (Pet. App. 16-18).

ARGUMENT

1. It is well settled that the income derived from the production of oil and gas, and the allowance for percentage depletion computed thereon, must be allocated among the parties to the production venture in proportion to their respective economic interests in the minerals in place. In the present case, the court below properly held that petitioners' interest, though in form a leasehold (or working) interest, was in

economic substance merely an interest in the net profits of the production.[5] Under the terms of the assignment and operating agreement between Richfield and Quality (the petitioners' assignor), Richfield was given exclusive control of the property; was obligated to provide, in the first instance, all capital for exploration, development and operation throughout the term of the relationship; was required to look solely to the production proceeds for recoupment of its expenditures, and thus alone bore the risk and burden if those proceeds failed to match expenditures; and alone stood to profit from the recoupment of expenditures through production, since Quality was not personally liable. Conversely, Quality had no control over the operation; was under no personal obligation to bear any portion of the expenditures; and looked for its reward solely to the net profits of production after Richfield's expenditures had been recouped. Thus, the economic substance of the transaction was that Quality transferred to Richfield the burdens and benefits of its working interest in the

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[5] The leasehold or working interest is the entire interest in the mineral less the customary royalty interest retained by the landowner executing the lease. The owner of the working interest has control over production and liability for all the costs and expenses of operation and production. A royalty interest is a right to receive a specified percentage of all oil and gas produced during the term of the lease which is free and clear of the expenses of operation and production for which the leasehold owners are liable. A net profits interest, as the name implies, is a right to receive a fraction of the leasehold owners' net profit from production. Breeding and Burton, *Income Taxation of Oil and Gas Production* (1961 ed.), Secs. 1.07, 2.03, 2.04, 2.06, 3.02.

property, while reserving a fractional participation in the net profits. Accordingly, the Ninth Circuit correctly concluded that the petitioners' basis for depletion must be measured by the net, and not by the gross, profits of production. The fact that petitioners retained legal title to a portion of the leasehold is not controlling; for, as this Court has frequently held, the right to depletion is governed by economic realities and not by the concepts of property law (*e.g.*, *Palmer* v. *Bender*, 287 U.S. 551). And, legal ownership aside, Quality was in precisely the same position as the taxpayer in *Kirby Petroleum Co.* v. *Commissioner*, 326 U.S. 599, who was concededly the owner of a net profits interest.[6]

2. While the decisions in this area have not been consistent, there is, we believe, no present conflict of views among the circuits requiring resolution by this Court.

The Sixth Circuit's decision in *T. K. Harris Co.* v. *Commissioner*, 112 F. 2d 76, is distinguishable. There the taxpayer, who owned real property, entered into an agreement with a gas company whereby the latter was to drill wells on the property at its own expense and to be reimbursed out of gas production. When the costs had been recovered, the wells were to become the property of the taxpayer, and the gas company was to continue operating the wells on specified terms and to buy the output. Thus, the gas company, un-

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[6] See also *Burton-Sutton Oil Co.* v. *Commissioner*, 328 U.S. 25; *Commissioner* v. *Southwest Expl. Co.*, 350 U.S. 308; *Grandview Mines* v. *Commissioner*, 282 F. 2d 700 (C.A. 9); *Commissioner* v. *Feli. Oil Co.*, 144 F. 2d 276 (C.A. 9).

like Richfield in the present case, had neither a legal interest in the property nor an equity interest in the production enterprise, except as a source from which to recoup its initial drilling costs; thereafter its dual role was that of an independent contractor performing services for a fee and a purchaser of the mineral product. In those circumstances, it would have been difficult to hold that the gas company had a taxable and depletable interest in the minerals in place. Instead, the Sixth Circuit held that the gas proceeds which were credited to the taxpayer's account on the company's books and applied toward reimbursement of its drilling costs constituted income to the taxpayer used by him to purchase the completed wells. Such a rationale would be impossible on the facts of the present case, and it is significant that the Sixth Circuit's approach is not the one urged by the taxpayer here.

Reynolds v. *McMurray*, 60 F. 2d 843 (C.A. 10, 1932), certiorari denied, 287 U.S. 664, although admittedly inconsistent with the decision below, is an old case whose reasoning has been outmoded by subsequent decisions of this Court. In that case, involving a fact situation substantially identical to the one here, the Tenth Circuit held that the taxpayer was taxable (and therefore entitled to depletion) on his share of the production receipts which went to reimburse the other leasehold owner for the expenses of development and operation he had advanced. But the decision rested chiefly on the ground that the taxpayer had retained legal title to the leases. Later, this Court established the principle that the taxability of

income from mining, and the right to depletion thereon, do not depend upon legal title, but upon the realistic economic interests of the mining venturers. *Palmer* v. *Bender*, 287 U.S. 551 (1933); *Kirby Petroleum Company* v. *Commissioner*, 326 U.S. 599 (1946); *Burton-Sutton Oil Company* v. *Commissioner*, 328 U.S. 25 (1946). In light of these supervening decisions, it is doubtful that the Tenth Circuit would adhere to *Reynolds* if the issue were now presented to it.

While *Commissioner* v. *J.S. Abercrombie Co.*, 162 F. 2d 338 (C.A. 5), is also at odds with the decision below, its authority has been greatly undermined by the Fifth Circuit's subsequent decision in *Weinert's Estate* v. *Commissioner*, 294 F. 2d 750. In the latter case, the court held (p. 755) that "the tax concept of 'economic interest' and not the common law concept of title must control the division of taxable income in the development and operation of oil and gas property" and hence that production receipts used to reimburse the "carrying party" for his outlays of expenses are taxable to him and not to the "carried party."[7] To be sure, the court did not ex-

[7] A "carried interest" has been defined as "an arrangement between two or more co-owners of a working interest, whereby one [the carrying party] agrees to advance all or some part of the development costs on behalf of the others [the carried parties] and to recover such advances from future production, if any, accruing to the other owners' share of the working interest." Breeding & Burton, *Taxation of Oil and Gas* (1961 ed.), Sec. 2.08; Pet. 17; *Weinert's Estate*, *supra*, 294 F. 2d 750. In referring to the carrying party's outlays as "advances * * * on behalf of" the carried parties, that defini-

plicitly overrule *Abercrombie*, but distinguished it on the dubious ground that there the taxpayer had retained legal title to the leasehold, whereas in *Weinert* the taxpayer had conveyed title to a trustee for the period of the pay-out. But the court stressed (pp. 756-757) that "the statements in [*Abercrombie*] emphasizing the common-law concept of ownership tend to weaken the tax concept of economic interest" and that *Abercrombie* must be narrowly interpreted. In addition, it cited, and impliedly endorsed, the existing administrative practice whereby the Service had so drastically limited the application of *Abercrombie* that, in the words of one commentator, "it would not be surprising if the Service were to refuse to apply the Abercrombie principle to an exactly similar factual situation unless the taxpayer's name were also J. S. Abercrombie Co." 294 F. 2d 757, fn. 14 (quoting Peck, *Recent Developments in Oil and Gas Taxation*, 10th Ann. Inst. on Oil and Gas Tax (S. W. Legal Fdn. 1959) 421). In light of those comments, and the express rejection of the rationale upon which *Aber-*

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tion might be thought to resolve in petitioners' favor the very question which is at issue here. Thus, the court below regarded as a point of contention whether petitioners in fact had a "carried interest" in the oil and gas in place (Pet. 17), and concluded that they did not. The "carried interest" terminology has, however, sometimes been used by commentators to describe the general type of arrangement involved in this case, without thereby implying any conclusion as to the tax consequences. While we have no objection to petitioners' use of the phrase, in this neutral sense, to refer to the arrangement here, we do not concede, of course, that Richfield's payments for expenses were advances or loans to Quality.

crombie, was decided, it appears that the Fifth Circuit's current position on this issue is in substantial accord with that of the court below, and that *Abercrombie* might now be overruled if a case on all fours with it were presented to the Fifth Circuit.

While the issue is undoubtedly important to the oil and gas industry, the applicable legal rules are sufficiently well-established that there is no need for review by this Court. At the administrative level, as we have noted, the Service has long ruled that, during the pay-out period (or, as here, during the life of the lease) the income which goes to reimburse the operator for the drilling and operating expenses he has incurred is taxable to (and depletable by) him, and not to the other leasehold owner who bears no risk; that *Reynolds* v. *McMurray*, *supra*, should not be followed; and that *Abercrombie* should be so narrowly applied as virtually to deprive it of any precedential value. G.C.M. 22739, 1941-1 Cum. Bull. 214, 223-224; *Weinert's Estate* v. *Commissioner*, *supra*, p. 757, fn. 14. The decision below merely confirms this settled administrative practice. Arrangements of the type involved here are commonplace in the oil and gas industry, and hundreds, if not thousands, of tax returns have been filed by the parties to such arrangements. Yet, so well accepted and widely understood has the Service's position been that the issue presented

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Prater v. *Commissioner*, 273 F. 2d 121 (C.A. 5), also cited by petitioners, was decided on the basis of *Abercrombie* and before *Weinert*. *Sowell* v. *Commissioner*, 302 F. 2d 177 (C.A. 5), dealt with an altogether different issue.

here has arisen in only a small handful of cases over the course of thirty years. We are advised by the Service that an informal review within the national office discloses no pending case in which a taxpayer having a net profits interest such as petitioner's has reported as income, or claimed the related deductions upon, an amount equal to "his" share of the expenses. Thus, unless there should emerge a live conflict among the circuits, we submit that there is no occasion for intervention by this Court.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1964

No. 113

JOSEPH M. THOMAS and
JILL G. THOMAS,
Petitioners,

vs.

UNITED STATES OF AMERICA,
Respondent.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

PETITION FOR REHEARING OF PETITION FOR A WRIT OF CERTIORARI

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PETITION FOR REHEARING OF PETITION FOR A WRIT OF CERTIORARI

Petitioners Present Their Petition for a Rehearing of this Court's Order Dated October 12, 1964, denying the Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit, and, in support thereof, respectfully show:

The Petition for a Writ of Certiorari herein was denied by Order of this Court on October 12, 1964. On the same date the Petition for a Writ of Certiorari was granted in *Paragon Jewel Coal Company, Inc., v. Commissioner of Internal Revenue*, 330 F(2d) 161 (4th Cir. 1964) (See Appendix hereto).

GROUNDS OF PETITION FOR A WRIT OF CERTIORARI

The Petition for a Writ of Certiorari filed herein was based upon the following grounds:

(1) The decision of the Court of Appeals for the Ninth Circuit is admittedly in direct conflict with the decision of the Court of Appeals for the Tenth Circuit in *Reynolds v. McMurray*, 60 F(2d) 843, the decision of the Court of Appeals for the Sixth Circuit in *T. K. Harris Company v. Commissioner*, 112 F(2d) 76, and the decisions of the Court of Appeals for the Fifth Circuit in *Commissioner v. J. S. Abercrombie Co.*, 162 F(2d) 338 and *Prater v. Commissioner*, 273 F(2d) 124.

(2) This case involves an important question of federal law which has not been, but should be, settled by this Court.

GROUNDS OF PETITION FOR REHEARING

This petition for rehearing is based upon the ground that the basic issues involved in the present case are the same as the basic issues involved in *Paragon Jewel Coal Company, Inc., v. Commissioner*, 330 F(2d) 161 (4th Cir. 1964), in which the petition for a

writ of certiorari was granted on October 12, 1964, that the review of the *Paragon* case by this Court will necessarily involve consideration of the issues in the present case and that a reversal of the decision of the Court of Appeals for the Fourth Circuit in the *Paragon* case would require disapproval by this Court of the principles applied by the Court of Appeals for the Ninth Circuit in the present case.

COMPARISON OF THE FACTS AND ISSUES OF THE PRESENT CASE AND THE PARAGON CASE

In the present case, petitioners' predecessor, Quality Oil Company, owned the entire working interest under an oil lease. Quality assigned a 70% interest in a portion of the lease to Richfield Oil Company, and at the same time the parties entered into an operating agreement under which Richfield was given the right to develop and operate the property. Richfield was required to advance the costs of development and operation and Quality was required to pay 30% of such costs, but its liability was limited to the proceeds from its share of the oil produced.

The operating agreement expressly provided that Quality was the owner of an undivided 30% and Richfield was the owner of an undivided 70% of the leasehold estate, and the oil and gas produced and saved, that each party had full right to sell or otherwise dispose of its share of the oil and gas and that Richfield had no authority to sell or otherwise dispose of Quality's share of the oil and gas produced and saved.

Quality agreed to sell its share of the oil and gas to Richfield at the market price.[1]

The property was successfully developed and the oil produced prior to the years at issue was more than sufficient to pay all exploration and development costs and operating expenses.

The issue involved is whether that portion o the proceeds received from the sale of petitioners' share of the oil which Richfield, as operator, applied in payment of petitioners' share of the operating expenses constituted gross income to petitioners for purposes of depletion or whether said portion of the proceeds should be added to Richfield's gross income for depletion purposes.[2]

In reversing the decision of the District Court, the Court of Appeals for the Ninth Circuit determined that, in spite of the express agreement between the parties with regard to their respective interests in the lease and in the oil produced, Quality in substance and effect assigned to Richfield so much of Quality's share of the oil and gas in place as would be needed to reimburse Richfield for Quality's share of the expenses. (Pet. Cert. App. p. 18.)

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[1]There was a similar partial assignment to and operating agreement with Hancock Oil Company of another portion of the leased property.

[2]Both parties agree that Richfield's gross income from the property included the gross proceeds from its full 70% after land owner's royalties and that Petitioners' gross income from the property was not less than their share of the net proceeds after deduction of all development and operating expenses. The dispute is whether the portion of the gross proceeds which was applied in satisfaction of Petitioners' share of the expenses was gross income to Petitioners or to Richfield.

The Court of Appeals also emphasized that Richfield bore the risk since it was required to advance the development and operating expenses and was to be reimbursed from the proceeds of the oil produced and apparently concluded that the party who bears the risk is entitled to the depletion regardless of who owns the oil.[3] (Pet. Cert. App. pp. 17, 18.)

In *Paragon Jewel Coal Company v. Commissioner*, supra, Paragon owned the working interest in a coal lease and entered into oral agreements with several operators to mine the coal from designated areas and deliver the coal to Paragon. The operators furnished their own equipment and paid their own operating expenses and were paid by Paragon at a specified rate per ton of coal delivered to Paragon.

The issue presented was whether the operators had an economic interest in the coal in place and were entitled to a deduction for depletion based upon the payments which they received from Paragon or whether Paragon retained the economic interest in the coal in place and was entitled to compute its gross income from the property, for depletion purposes, without reduction for the payments to the operators.

The Court of Appeals for the Fourth Circuit determined that the investments of the operators in equipment and in the production of the coal gave them the right to mine the property to exhaustion and that this right together with their investment

[3]During the years at issue the risk was entirely theoretical since the production greatly exceeded the costs of production.